The Efficiency of Credit

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A GOOD irrigation system and a perfect system of credit would exhibit strikingly similar characteristics. The supply of credit, as of water, would be abundant, produced at a minimum cost, and free from interruption or exhaustion. Adequate means of distribution would be developed to furnish the water in the one case and credit in the other to every part of the territory to be served. And then, to secure good results, judgment must needs be exercised in both cases. Unintelligent and lavish use of the water will be harmful to the crops and may exhaust the most abundant sources of supply. Similarly with credit, unrestrained use has an unfavorable effect upon industrial output, stimulates a rank growth of speculation and is the principal cause of extreme fluctuations in the general level of prices. Irrigation experience also teaches that extensions and improvements in one direction may be wasteful and even positively hazardous unless they are accompanied by balancing developments in other directions. This essential requirement, if a credit system is to develop in a satisfactory fashion, is commonly overlooked. The establishment and operation of the Reserve Banks has introduced many and important changes in our banking system. Whether that development has been a well balanced development is, in my judgment, the most searching and important question raised by our credit experience during the last six years.

MORE CREDIT AT LOWER COST

An increase in the supply of credit and a reduction in basic costs are definite results of the changes in our banking arrangements brought about by the establishment and operation of the Reserve Banks. The reduction in reserve requirements for member banks and the concentration of those reserves in the Reserve Banks, where they become in turn the basis for further credit in the form of Federal Reserve notes and also of reserve balances, have greatly reduced the amount of gold or other reserve money required to support a given volume of credit. Estimates of the saving thus secured vary somewhat, but for our present purpose it is sufficient to note that all calculations agree in the conclusion that gold is now a basis for at least twice as much credit as in the period before the Reserve System was established.

A reduction in the amount of gold required to support a given volume of credit would be followed by a positive reduction in the cost of bank credit if the volume of credit was not enlarged. Less gold would then be used for banking purposes, and the surplus could be used in the arts or exported in payment for goods, services or securities. Again, insofar as additional credit might serve to increase production, a positive advantage would be derived from the reduction in reserve requirements. But manifestly the amount of additional credit that can exert a favorable influence upon production is small. A large increase in the supply of credit, if freely used, is a positive detriment to industry. Its effects are seen in rapidly advancing prices, an over-extended condition of business concerns generally, and widespread speculation, culminating in crises and followed by trade depression.

Leaving out of consideration the special case of the use of credit in financing the War, it is not easy to discover any positive gain that the country has realized from economy of gold which has been secured through the establishment of the Reserve System. So far, the results have been unfavorable. The additional credit was freely extended and we now are enduring the inevitable consequences. So far as the supply of credit is concerned, a repetition of this experience is entirely possible. Loan liquidation, always an incident of periods of depression and abnormal gold imports, is placing the banks in position to grant billions of additional credit as soon as an active demand develops.

A more certain gain from the Reserve System is the assurance that the flow of credit will not be interrupted through exhaustion of supply or by the working at cross purposes of the banks as happened in successive crises down to and including the crisis of 1907. This assurance that the flow of credit will not be interrupted in the future is not the result of the increase in the supply of credit. It could have been gained without any increase whatever in credit supply. The exhaustion of the lending power of the banks on future occasions of financial strain is altogether unlikely because the Reserve Banks recognize responsibility for the general credit situation in this regard, and regularly hold in reserve, power to extend credit on an extensive scale to be used freely in case of emergency. Through the Reserve System the banks of the country have also become closely knit together for settlement purposes, and there is therefore no longer reason to fear that they will suspend payments on future occasions of financial strain. In short, that a future crisis will degenerate into a panic is no longer one of the hazards to which the conduct of business is subject.

THE DISTRIBUTION OF CREDIT

Turning now to the distribution of credit, the Reserve System is found to have made considerable, though by no means fundamental, changes. On account of the almost complete absence of branch banking in the United States, credit is far less fluid in this country than elsewhere. The supply of credit in each community, and especially in the smaller ones, is in large measure limited to the resources of the local banks eked out by such amounts as they may choose or are able to borrow from banks in other places. Through the Reserve Banks the borrowing facilities of many local banks have been materially enlarged. But it still remains true that credit is far less fluid than in the countries where banking is conducted by banks operating regional or nation-wide systems of branches. This is the price, not necessarily too high a price, that we pay for our system of independent local banks.

It is in the employment of credit that the least change has followed the establishment of the Reserve System. Aside from certain general restrictions, each local bank, and properly, is free to employ its funds as may seem to it advisable. The Federal Reserve Act widened the scope of the lending activities of the banks somewhat by authorizing them to accept a limited range of bills of exchange and to lend a moderate amount on mortgage security. The Act also aimed at making commercial loans more attractive by excluding other loans, with the exception of those secured by United States government obligations, from rediscount at the Reserve Banks.

These changes in the law and modifications in banking practice are im-

portant, but were not expected to change materially the general character of the assets of the banks.

More Credit Without New Uses

This, then, is the gist of the situation resulting from the establishment and operation of the Federal Reserve System: an enormous increase in the available supply of credit and no considerable new uses for this credit. No new uses for credit are needed to absorb this additional supply. The bulk of this additional credit cannot be employed with advantage to the community, but only to its positive disadvantage. Credit serves a productive purpose by facilitating the transfer of capital assets and of goods in process of production and marketing. But when business is active, and people are already fully employed, additional doses of credit do not result in a larger physical output of goods. Additional credit then subjects all industry to the unhealthful influence of protracted advance in prices. The demand for credit grows more and more intense and is practically without limit. At such times, moreover, the thousands of competing banks are quite incapable of imposing restraint upon borrowers so long as they possess unused lending power. The fear that desirable depositors will go elsewhere is strong and warps judgment. In these circumstances, cautions and warnings from the Reserve Banks have little effect; they were not heeded in 1919.

The Reserve Banks now have a reserve which is nearly 75 per cent of their demand liabilities, with prospects good for a still higher ratio before conditions become favorable for a period of renewed business activity. Rediscounts to the amount of about $3,000,000,000 could be granted and still, in the absence of gold exports,—an unlikely event—the Reserve Banks would be well within legal reserve requirements. On the basis of the credits secured through these rediscounts the commercial banks of the country would be able to extend loans by from two to three times the amount discounted. In other words, it may be conservatively estimated that there is at least ten billion dollars of unused bank credit in the United States at the present time.

The Discount Rate and the Price Level

In the Federal Reserve System we have an agency which has the power to make a vast increase in the supply of credit for the bulk of which there is only one influence that will create an intense demand. That influence is rising prices. A moderate advance in prices may indeed have a beneficial effect on production after a period of depression, but a prolonged upward swing of prices creates speculative conditions, stimulates speculative activities, and tends to bring all but the most cautious business concerns into an over-extended condition. Such a prolonged upward movement of prices with all its disastrous consequences is hardly possible without large use of the credit resources of the Reserve Banks. It would seem, therefore, that the effect of advancing prices on the general business situation should be a factor of the first importance in shaping the discount policy of the Reserve Banks, assuming more and more importance as a period of business activity continues. The management of the Reserve Banks is, however, by no means inclined to this view of the matter. Responsible officers of the banks and also members of the Federal Reserve Board roundly assert that they are not concerned with the course of prices and that in the determination

of discount policies the price situation is not a definite factor.

The attitude of the management of the Reserve Banks in regard to responsibility for the course of prices forcibly recalls an experience of the most ancient of central banks. For more than a generation, the directors of the Bank of England stoutly insisted that the Bank was no more responsible for the situation in time of crisis than any other London bank. Finally, largely as a result of repeated onslaughts by Bagehot in *The Economist*—given more permanent form in *Lombard Street*—the policy of the Bank was definitely reversed and the course that has become universal practice in handling crises was adopted.

There is unhappily little doubt that the Reserve System has lost somewhat in general public estimation during the last two years. It bears much of the burden of the consequences of the unwise low discount policy which the Treasury Department unwisely insisted must be continued for more than a year after the Armistice. The wisdom subsequently manifested in refusing to give way to demands for additional credit, which would have made a bad situation worse, could not be expected to make a strong appeal to the people at large. For the future, if not prevention, at least clear evidence that the Reserve System has not contributed to the creation of the intense activity that breeds depression is a reasonable demand on the part of the public. This expectation will not be realized if large additional supplies of credit are furnished by the Reserve Banks at times when prices are rising rapidly and persistently.